June 8, 2023

Trevor McGowan
Associate Assistant Deputy Minister
Finance Canada
90 Elgin Street
Ottawa, Ontario
K1A 0G5
Via email: Trevor.McGowan@fin.gc.ca

Dear Trevor:

Re: Budget 2023 Proposals Relating to the Alternative Minimum Tax (AMT)

The Conference for Advanced Life Underwriting (CALU) is pleased to make this submission to the Department of Finance (Finance Canada) relating to proposals announced in the 2023 federal budget (Budget 2023) that will significantly modify the application of the Alternative Minimum Tax (AMT). While we are generally supportive of the stated intent of narrowing the application of the AMT to high-income Canadians, we have several concerns and related recommendations which are outlined in this submission.

CALU is Canada's national association for leaders in the life insurance and financial advisory industry. Our members include insurance and financial advisors as well as accounting, tax, legal and actuarial experts. Along with our partner organization, Advocis, we speak for more than 17,000 insurance and financial advisors in every part of Canada to grow and preserve the financial well-being of Canadians and family businesses.

Background

In the 2022 federal budget (Budget 2022) the federal government proposed to review the taxation of high-income earners to ensure that they pay their fair share of tax. In the Budget 2022 materials, Finance Canada reported that among individuals with gross income over $400,000 and who filed a tax return in 2019, an average of 28 per cent were only paying federal income tax at an effective rate of less than 15 per cent, and approximately 10 per cent of those individuals paid federal income taxes at an effective rate of 5 per cent or less.

Budget 2023 now sets out the proposed changes to the AMT rules, including:

- Increasing the AMT rate from 15 per cent to 20.5 per cent
- Increasing the AMT income calculation deduction from $40,000 to the amount that is the start of the fourth federal tax bracket for individuals (approximately $173,000 in 2024, with indexation to inflation)

- Increasing the capital gains inclusion rate from 80 per cent to 100 per cent while decreasing the deduction permitted for capital loss carry forwards and allowable business investment losses to 50 per cent[1]
- Including in income for AMT purposes 100 per cent of the benefit associated with employee stock options (which is reduced to 30 per cent if the securities are donated) and 30 per cent of capital gains realized on the donation of publicly traded securities
- Disallowing 50 per cent of a variety of deductions in calculating income for AMT purposes,
- In determining income for AMT purposes, allowing only 50 per cent of non-refundable tax credits, subject to certain exceptions including that the rules will continue to include the cash amount of dividends (i.e., not the grossed-up dividend) and fully disallow the dividend tax credit.

The proposed changes are stated to apply for tax years that begin after 2023.

Concerns with the Proposed AMT Changes

1. Potential Impact on Taxpayers with a "One-Time Large Income Event"

While we agree that the increased AMT income deduction of approximately $173,000 will ensure most Canadians do not pay AMT, we are concerned that the proposed AMT changes could adversely taxpayers who experience a large one-time income event. This situation can arise with some frequency for farmers, fishers and small business owners who have built up the value of the business over their lifetime which is then monetized as part of their retirement planning. There may however be additional situations (such as an individual who owns personal-use real estate that has significantly appreciated in value) where similar concerns can arise.

For example, consider the situation of Sally, who is widowed and owns shares in a farming corporation that qualifies for the life-time capital gains exemption of $1 million. Sally has been receiving a salary of $100,000 per year and declares additional dividends when the profitability of the farm business permits. She has been able to accumulate $100,000 in RRSPs and also has unused RRSP contribution room of $240,000. Sally also has $100,000 in a tax-free savings account and has $200,000 in GICs earning a 4 per cent rate of return. Sally turns 62 in early 2024 and receives an unsolicited offer of $1.5 million for her shares in the farm corporation from an arm's length person, payable in full on closing. Sally decides to accept this offer and the share sale is completed by mid-year.

Sally uses $250,000 of the net after-tax sale proceeds to renovate her home. The remaining proceeds of $1.1 million are invested in equities that generate an average 7 per cent return (of which 4 per cent is capital gains and 3 per cent is dividend income). She does not plan to trigger payments from her RRSP until age 71 and will withdraw funds from her TFSA if required for unexpected expenses.

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[1] Budget 2023 indicates that capital gains eligible for the lifetime capital gains exemption (LCGE) will continue to have a 30 per cent inclusion rate for AMT purposes. For the purposes of this submission, we have assumed this means that the inclusion rate for capital gains eligible for the LCGE will continue to be 80 per cent.

For 2024, under the regular tax system, Sally will declare $50,000 of employment income, $500,000 in capital gains (from the sale of her shares) plus $22,000 in capital gains, $8,000 of interest income and $16,500 in taxable dividends (from her various investments), resulting in a Part I federal tax payable of approximately $85,000.[2]

Sally's income for AMT purposes would be equal to $896,500 ($50,000 (salary) + $8,000 (interest income) + $800,000 ((80 per cent x $1 million capital gain eligible for the LCGE and 100 per cent x $500,000 for the remaining capital gain) - $500,000 (capital gains deduction)) + $22,000 (100 per cent x $22,000 capital gain) + $16,500 (dividend income)). This would result in AMT of approximately $148,000. Sally would therefore have to pay an additional $63,000 in federal taxes in 2024.[3]

Based on an annual income from her investments (approximately $85,000 – consisting of a mix of interest income, capital gains and dividend income) and an annual RRSP deduction of $10,000,[4] Sally would have Part I tax of approximately $1,500 per year over the next seven years (total of $10,500). The result is that Sally cannot recover approximately $52,500 in AMT.

As noted, the issue for Sally is that she has experienced a large one-time income event as she is entering her retirement years, which in turn exposes her to a significantly higher amount of AMT than under the existing rules.[5] This makes it even more difficult for Sally to recover the AMT over the following seven taxation years.

To deal with this concern we are recommending that taxpayers (other than trusts) be provided with the option to "look back" to the three immediately preceding taxation years and obtain a credit against their current AMT to the extent that Part I federal tax exceeds AMT in any of the three immediately preceding taxation years. The calculation of AMT would be based on the rules that existed in those taxation years.

For example, assume that in 2023 Sally had salary of $100,000, taxable dividends of $50,000[6] and $8,000 of interest income. Her regular Part I federal tax for the year would be approximately $25,000 and her AMT would be $18,000 (($158,000 – 40,000) x 15 per cent).[7] The difference of approximately $7,000 could be credited against her AMT payable in 2024. She could also claim credits for the 2021 and 2022 taxation years assuming Part I federal tax was higher than the AMT in those years.[8]

We would also note that Sally could also be penalized to the extent she attempts to claim her unused RRSP contribution room in future taxation years. Such contributions would reduce Sally's Part I federal taxable income and would impact her ability to recover the AMT payable in 2024.

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[2] Using 2022 tax rates.

[3] This is calculated as ($896,500 - $173,000) x 20.5 percent (ignoring personal tax credits).

[4] From her unused RRSP contribution balance of $240,000.

[5] The AMT payable under the current rules applicable in 2023 would be approximately $113,000 calculated as follows: (($50,000 (salary) + $8,000 (interest) + $700,000 ((80 per cent x $1.5 million - $500,000 capital gains deduction) + $17,600 (80 per cent of $22,000 + $16,500 (dividend income)) - $40,000) x 15 per cent. This ignores the value of personal tax credits.

[6] Paid to her by the farming corporation.

[7] The AMT calculation ignores personal tax credits.

[8] Note that to the extent Sally takes advantage of an "AMT credit" from the 2021, 2022 or 2023 taxation years, it reduces any available credit from those taxation years should an AMT liability arise again in 2025 or 2026.

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In summary, we believe the three year "lookback" would help address situations where a taxpayer (other than a trust) may have an unusual and significant income event resulting in the payment of AMT, and they have insufficient taxable income in subsequent years to recover the AMT.

2. Application of AMT to Trusts

While all inter vivos and testamentary trusts are generally subject to the AMT,[9] such trusts (other than graduated rate estates) are not currently entitled to apply the $40,000 deduction in calculating income subject to AMT, which is available to other individual taxpayers. This currently does not result in a significant impact on the AMT payable by a trust, as the $40,000 deduction represents a potential AMT saving of $6,000 in any particular taxation year.[10] As well, in many situations trusts will distribute all their income (including capital gains) to beneficiaries to avoid paying tax at the top marginal tax rate on such income.

However, the inability to apply the proposed increased deduction of $173,000 (indexed) could have a significantly greater impact in situations where a trust does not, or is not permitted to, distribute all its income (including capital gains) to the beneficiaries.[11] For example, a trust may have been established for the spouse of a second marriage, with the intent that on the death of the spouse, any remaining capital will be distributed to children of the first marriage. In these circumstances the trust may include terms that restrict the distribution of capital gains to the spouse beneficiary to protect the interests of the children as residual beneficiaries. As a result, while the spouse beneficiary is alive, all the capital gains must be taxed in the trust. Without the $173,000 (in 2024) deduction, the trust would be subject to AMT each year on its capital gains, however small, and may not have other income to utilize the AMT deduction from regular income tax in future years.

We are therefore recommending that all trusts be entitled to the same deduction available to all other individual taxpayers. Thus, to the extent that income is retained in a trust, there will be a deduction of $173,000 (in 2024) in determining the income subject to AMT in the trust.

In Summary

As noted at the beginning of this submission, while CALU is generally supportive of the stated intent of narrowing the application of the AMT to high-income Canadians, we have concerns relating to the application of these changes to certain individual taxpayers and trusts and believe our recommendations will help manage these concerns while meeting the government's stated goals in amending the AMT rules.

Once again, we appreciate this opportunity to provide input on the proposed AMT rules and would be pleased to engage in further dialogue on this issue.

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[9] There is an exception under paragraph 127.55(e) for life interest trusts in the year the life interest beneficiary dies, which event triggers a deemed disposition of certain capital property to the trust.
[10] This is calculated as 15 percent of $40,000.
[11] The inability to apply the deduction can result in additional AMT of up to $34,465 in 2024 ($173,000 x 20.5 per cent).

Yours truly,

Guy Legault *Robert McCullagh*

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